



# Rapid Economic Growth without Economic Freedom: A Puzzle Made in China

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## Abstract

Adam Smith's well-known book, *An Inquiry into the Nature and Causes of the Wealth of Nations*, shows that free markets, the protection of private property rights and a minimal government interference in the economy lead to prosperity. The development economics literature has expansive evidence that economic freedom and sound legal, financial and political institutions boost economic growth.

China's economy has grown by nearly 10% each year for over three decades. Yet China's phenomenal economic growth has been accompanied by a relatively underdeveloped legal and financial system. For instance, China is the 124th freest economy in the 2008 *Index of Economic Freedom*.

China seems to be an outlier in the economic growth and freedom literature.

## The Index of Economic Freedom

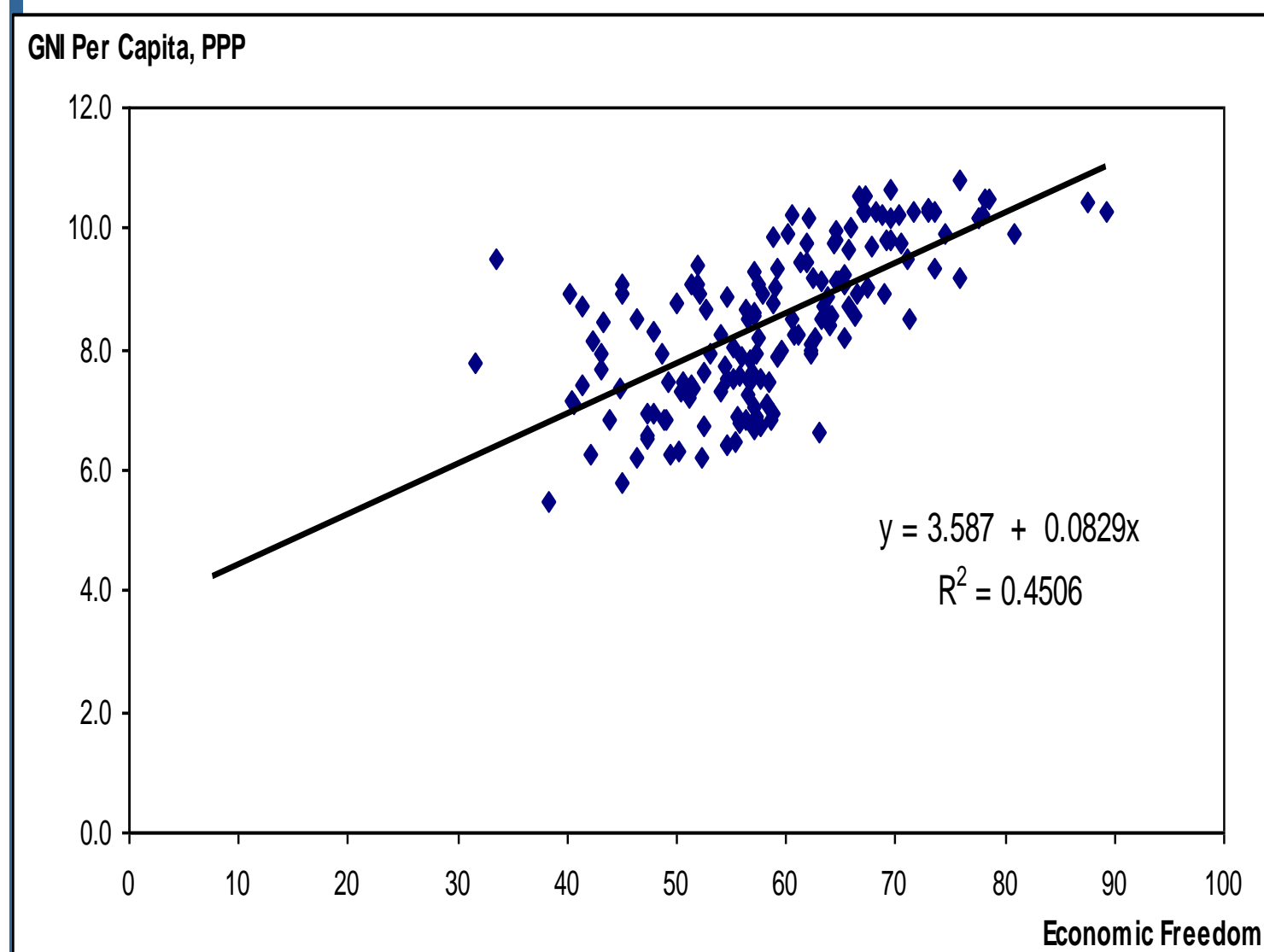
The index creates ten benchmarks that gauge the economic success of most countries around the world. The higher the score on factor is, the lower the level of government interference in the economy. Countries with very high freedom scores of 80 or more are considered as "free" economies, followed by "mostly free", "moderately free" and "repressed."

In the 2008 rankings, Only seven nations were believed to have free economies. About one-third of the countries (51 economies) were moderately free. Another one-third economies (including China) were mostly unfree.

## Link between Economic Freedom and Prosperity

In Figure 1, prosperity is measured by a nation's gross national income (GNI) per capita. A country's GNI is converted to the U.S. dollars using the purchasing power parity (PPP) implied exchange rates.

Figure 1 Prosperity and Economic Freedom



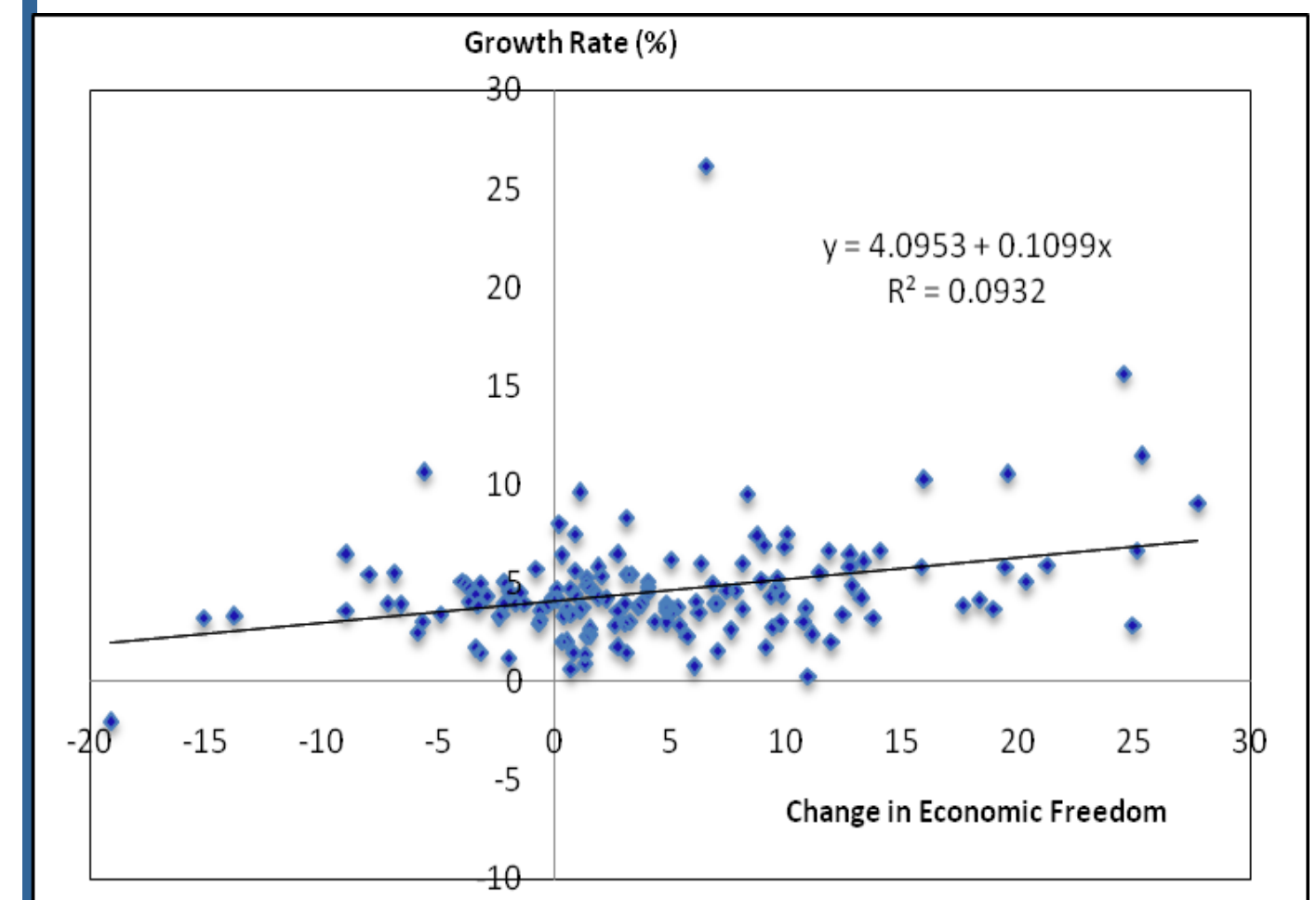
Prosperity is regressed on the average economic freedom index. The coefficient estimate of economic freedom is positive and statistically significant.

## Economic Freedom and Economic Growth

A empirical model is established in which economic growth is a function of the level of economic freedom, the change in economic freedom, and a vector of control variables that include the starting PPP-based GNI per capita, gross capital formation as a ratio to GDP, population growth, the ratio of exports of goods and services to GDP and inflation rate.

It is found that real GDP growth is significantly and positively associated with the change in economic freedom (see Figure 2).

Figure 2 Relationship between Economic Growth and Change in Economic Freedom



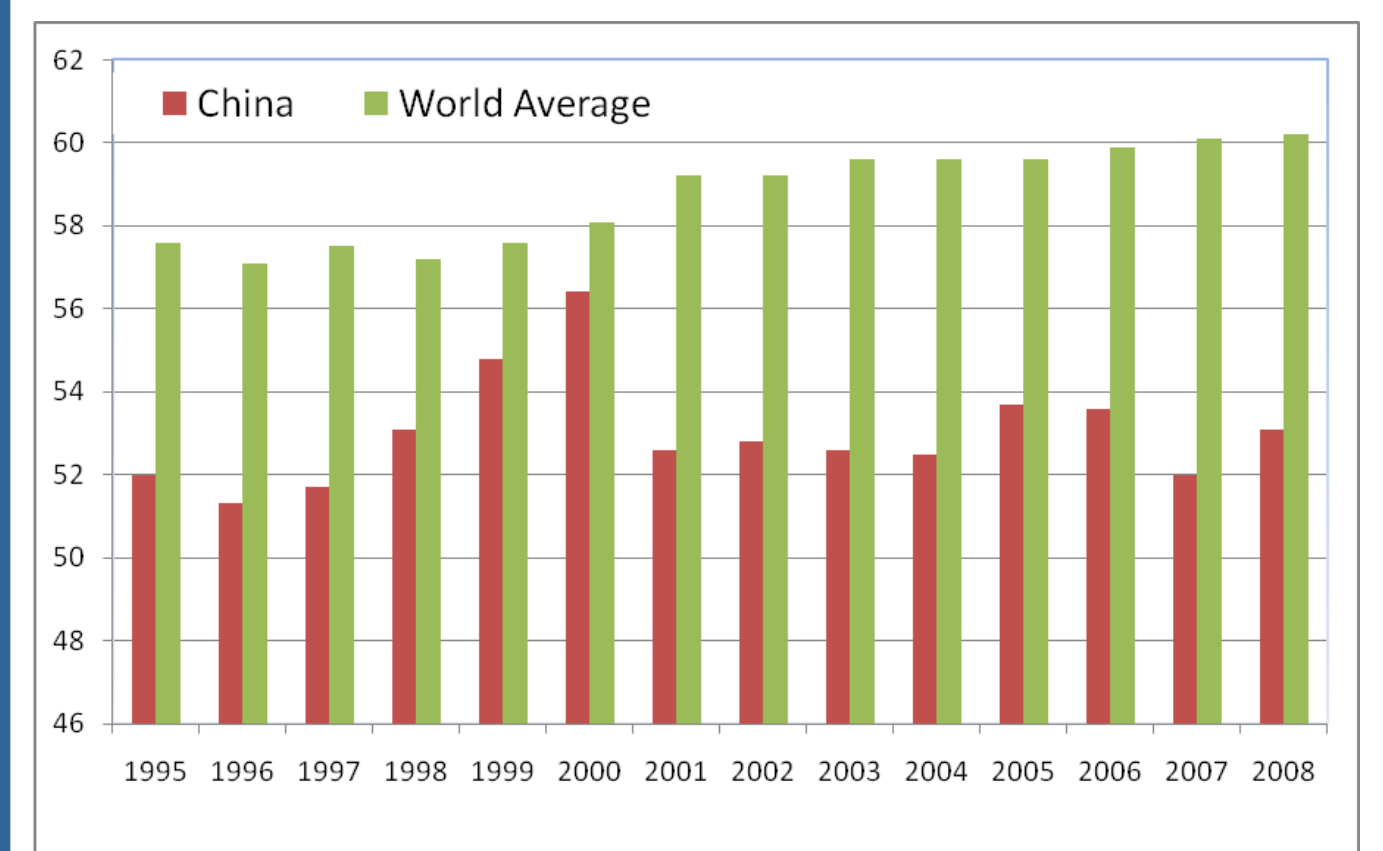
The correlation between economic growth and the change in economic freedom is significantly positive.

## Economic Freedom in China

China's ranking in economic freedom has been consistently below the world average, barely above the "repressed" category. And it shows no improvement at all.

For example, its freedom score is 53.1 in 2008, well below the world average of 60 (see Figure 3). China is the 124th freest economy in the 2008 *Index of Economic Freedom*.

Figure 3 Economic Freedom: China vs. World



## Introduction

The basic ideas of Adam Smith let economists to take an interest in economic and political institutions. Recent empirical work has analyzed country-level data on the gross domestic product (GDP) etc .Another line of empirical research focuses on the link between economic freedom and economic growth.

I investigate the association between the Index of Economic Freedom, and the Wall Street Journal, and the real GDP growth across countries. And I find that countries whose economic freedom improves have faster economic growth.

China seems like a counterexample to the findings in law, institutions, finance and economic growth literatures. So what is the secret to China's economic miracle? Can it continue without sound legal, financial and political institutions? These issues are too broad and complicated. This study attempts to shed some light on this thorny issue.

## The China Puzzle

China's low economic freedom ranking is in sharp contrast to its amazing economic performance. China's average annual growth rate of 9.64% makes it the seventh fastest growing economy overall among the 153 countries during the 1995-2008 period. The growth model based on cross-country data fails to explain China.

In conclusion, China is a notable counterexample to the findings in law, institutions, economic freedom and economic growth literatures.